Bizarre Behavior?

The Story of Enron Stock Losses in the Florida State Employee Retirement Fund

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Testimony before a hearing on Examining Enron: The Consumer Impact of Enron's Influence on State Pension Funds

Subcommittee on Consumer Affairs, Foreign Commerce and Tourism
Committee on Commerce, Science and Transportation
U.S. Senate
The Honorable Byron Dorgan, chairman

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Mr. Chairman and members of the subcommittee:

My name is James K. Glassman. I am a resident fellow at the American Enterprise Institute and host of the website TechCentralStation.com. I am also a syndicated financial columnist for the Washington Post and author of two books on investing. I have devoted much of my professional career to educating and advising small investors. I am deeply concerned about the effects of the Enron scandal on these investors and congratulate you for holding this hearing today.

Currently, more than half of all U.S. families own stock, compared with just 15 percent in the mid-1960s and 20 percent in the early 1990s. This is an enormously beneficial development. Americans primarily own shares of individual companies, mutual funds run by professionals, or index portfolios, which are baskets of stocks, maintained by computer programs, that reflect broader markets. The Enron disaster has been costly and shameful, but it provides a valuable educational opportunity for investors. It is important that members of Congress help them draw the right lessons.

I worry that in hearings like this one, investors get a dangerous message – that they are not personally responsible for their investments. For example, many Florida officials have, unwittingly or not, given the public the impression that the way the stock market works is that you keep your gains and sue to recover your losses – since they must be someone else's fault. In this view, investing is an endeavor that always produces winners, so, if there are losers, they someone must have cheated.

Instead, the most important lesson of the Enron collapse should be that investors assume risks when they invest in stocks, and they need to protect themselves. This hearing asks witnesses to comment on how losses such as those in the Enron case could be "avoided in the future." They cannot. Some stocks will always fall in value. The market as a whole has fallen in 22 of the past 76 years. Investors need to know that short-term losses are part of investing.

Stocks are risky.

However, the risk that a company will use deceptive or illegal accounting practices is a highly unusual one. Share prices of America's very best companies, with good managers, good products, good employees and good ideas, will fall from time to time – with no chicanery or lawbreaking involved.

In early 2000, for example, the stock-market value of Procter & Gamble, a sound corporation with great brand names like Tide and Crest, dropped by 54 percent in just two months. Volatility is inherent in stock investing. And volatility means that some stocks can rise by 7800 percent in a decade (as Dell Computer has done) while others, like Enron can go from $80 to a few cents in a year.

Stocks Are Risky, But Rewards Are High

In fact, the way to understand why stocks have been such a great investment over the past two centuries in the United States is to recognize that investors get compensated for taking risks. Since 1926, a portfolio the 500 stocks of the Standard & Poor's benchmark index (or its predecessor) has returned an annual average of 7.6 percent after inflation, compared with an annual average of just 2.2 percent, also after inflation, for medium- and long-term U.S. Treasury bonds. In other words, over 30 years, an investment of $1,000 in stocks rose, on average, to $8,000, while a similar investment in bonds rose to less than $2,000.

A smart investment strategy, then, is one that harnesses risk, dampens it, tries to control it. But eliminating risk in the stock market is impossible.

The best way to harness risk is through diversification – that is, owning lots of stocks in different sectors, so that the inevitable losers are offset by winners. Well-run pension funds typically hire several managers with different, often uncorrelated investing styles; each of the managers is responsible for a portion of the fund's assets. Small investors can get the same effect by owning different kinds of mutual funds: a growth and income fund, for example, that concentrates on large-company stocks that pay dividends, might be balanced by a small-cap aggressive-growth fund, whose manager looks for smaller firms that are often ignored by the public and by analysts, or by a fund that concentrates in Asian-based companies.

One thing I tell my readers is that stock investing is a long-term endeavor. There will be rotten years and great ones. Bonds are short- or medium-term investments; stocks are not. The only way to judge a portfolio manager is over the long term.

The Alliance Losses

It is with this approach that I have analyzed the events I first saw described in an article that appeared on March 3, 2002, in the New York Times. It reported that Alfred Harrison, a money manager for Alliance Capital, had lost $328 million through his investments in Enron Corp. on behalf of the Florida state pension fund.

The article asked why Mr. Harrison had bought Enron at the "11th hour" – that is, as late as two weeks before Enron filed for bankruptcy. The clear implication was that Mr. Harrison had done something terribly wrong, unprofessional, even corrupt.

I had heard of Mr. Harrison since I write about mutual funds, and knew he had an excellent reputation for his management of Alliance Premier Growth, a fund that had consistently beaten its peers. As I read the entire article and did some research on my own, a different picture emerged. It became clear that Mr. Harrison's critics lacked a basic understanding of how markets work and that they were making him a kind of scapegoat for some reason, perhaps political. But, more important, I worried that the way the story was treated might lead small investors – the people for whom I write – to draw the wrong conclusions about their own investment strategies.

Let me be specific….

1. The loss of $328 million in Enron stock came in a pension fund portfolio of $95 billion. In January 2001, Enron represented about 0.53 percent of the S&P 500 index, a good proxy for the market as a whole. A quick calculation finds that Mr. Harrison's peak holding of Enron represented about 0.3 percent of the Florida pension fund. In other words, if anything, Enron appeared to be underweighted in the Florida portfolio.

2. Mr. Harrison had been managing a piece of the Florida pension fund since 1984, presumably with annual reviews. Why hadn't Florida fired him earlier? Very simply because Mr. Harrison had increased his initial stake from $345 million to as much as $6 billion in about 15 years, according to published reports. When his contract was terminated, the stake had fallen to $3.7 billion – but that was still a 10-fold increase in 17 years, for an average annual return of 16 percent, considerably above the returns of the market as a whole.

3. Mr. Harrison is well-known for a particular style of investing. He takes extra risks and generally achieves extra rewards. Morningstar Mutual Funds, a research firm, calculates that, for the public fund he has managed since 1992, his investments have been about one-third riskier than the market as a whole. It is hard to believe that the Florida authorities were unaware of that style. Money managers operate in public; their records and strategies are well-known. Mr. Harrison, in fact, has a reputation for trying to find undervalued companies whose price, he believes, will rise. A well-run pension plan balances a manager like Mr. Harrison with other managers who might specialize in income-producing stocks or mid-caps or bank stocks.

4. Mr. Harrison was faulted for buying Enron as the price fell. The New York Times quoted Tom Gallagher, the Florida state treasurer and one of the state pension fund's three trustees, as saying, "Only fools buy on the way down." In fact, good investors, who believe in the companies in which they put their money, prefer to buy stocks at lower, rather than higher prices. Most smart investment analysts would generalize the opposite way: "Only fools sell on the way down – and buy on the way up." If you have found a good company in which to invest, and have bought its shares at $50 each, then it makes sense to buy more of those shares at $10 each. The question with Enron was its soundness as an investment, not the fact that its price had dropped. Indeed, Mr. Harrison frequently invested in stocks that had dropped in price, and, if Mr. Gallagher thought this something "only fools" do, then it is hard to understand why Mr. Harrison was retained for 17 years. In the right hands, Mr. Harrison's approach is a very effective strategy. For example, according to published reports, Mr. Harrison made a profit in the Florida fund by investing in Continental Airlines last year. He bought the stock after it fell shortly after the terrorist attacks in New York and Washington in September. Not long afterwards, it rose strongly, and Mr. Harrison made what the Times called "a quick large gain."

5. Enron's value in the stock market fell sharply when, on Oct. 16, 2001, it announced a reduction of shareholder equity of $1.2 billion because of partnership losses. Then came further shocks: the announcement on Oct. 22 of an SEC inquiry and the announcement on Nov. 8 of an overstatement of profits over the previous five years. Between Oct. 22 and Nov. 16, Harrison bought $35 million worth of Enron at prices ranging from $9 to $23 a share. The question is whether this investment was reckless. A little math is in order. This investment represented less than 1 percent of his total Florida portfolio under management and less than four-one-hundredths of one percent of the entire Florida pension fund. Specifically, the New York Times cited the $12 million he invested between Nov. 13 and 16 and called it "a huge bet that the company's prospects would turn around." In fact, it was not a huge bet – it represented one-three-hundredth of Mr. Harrison's Florida portfolio and about one-ten-thousandth of the entire pension fund. Clearly, in hindsight, Mr. Harrison made a mistake. He evidently believed that Enron's assets remained substantial and that the company would be bought out by Dynegy, a competitor. The Dynegy deal fell through on Nov. 30, and Harrison liquidated his Enron holdings that day. Two days later, Enron filed for bankruptcy protection.

A 'Bizarre' Decision?

Let me be clear. I certainly would not have invested in Enron in October, nor would I have advised my readers to do so (and many of them asked). The reason, very simply, is that for small investors I advocate a strategy of buying companies with solid long-term (meaning 20 years and more) prospects. But was Mr. Harrison's decision "bizarre," as Sen. Bill Nelson is quoted as saying? Not in my opinion. It is important to remember humility in viewing the workings of markets. The price of a stock is the considered judgment of thousands of investors – for every seller, there is a buyer. After the adverse revelations, the fact that Enron stock "was plummeting," in Sen. Nelson's words, did not make it an imprudent investment. For example, by definition, $10 a share was the best (that is, the most informed) price for Enron Nov. 14, one of the dates on which Mr. Harrison made one of his purchases. Yes, it turned out to be a bad investment, but Harrison also had many good ones, including, according to press reports, MBNA, Motorola and Cisco Systems. These stocks were bought according to the strategy that had produced good results for his clients – a strategy that his promotional literature calls "V investing" – that is, buying companies whose shares had fallen beyond what he believed to be reasonable levels and then selling them when they recovered, as many did.

Overall, Mr. Harrison not only beat the S&P with his Florida-fund portfolio but, with his public mutual fund, also beat the large-cap growth group and the Russell 100 Growth index, according to Morningstar. In addition, from 1994 to 1999, his fund beat the S&P in four out of five years. It returned 46 percent in 1995, 23 percent in 1996, 32 percent in 1997, 48 percent in 1998, and 28 percent in 1999.

A Kind of Hysteria

The Enron collapse has, unfortunately, generated a kind of hysteria. In fact, what is bizarre is not so much the behavior of portfolio managers like Mr. Harrison but the behavior of many journalists and public officials. Enron was a costly episode, but I fear that the search for scapegoats will end up, not merely smearing the reputations of talented and dedicated professions, but will send small investors – that is, your constituents – a disastrously wrong message.

Mr. Harrison was not the only money manager or analyst who was impressed by Enron's historic results, its business strategy, its management and its story. The company was lauded by Fortune magazine for many years as America's most innovative. In late September 2001, after Enron's stock price had fallen by two-thirds, the Value Line Investment Survey, an independent research firm with an excellent reputation, gave the company an "A" rating for financial strength and a "2" (above-average) rating for "timeliness." The Value Line analyst wrote, "We think fears are overdone…and…markets for both wholesale and retails services are still growing strongly." After all, revenues had risen from $14 billion to $100 billion in 10 years, and earnings had gone from 9 cents a share in 1989 to $1.47 a share in 2000.

Janus, one of the biggest mutual fund houses in the country, owned 5.6 percent of the company's shares by itself, and the Fidelity sector fund that specializes in energy made Enron its largest holding. Alliance and Mr. Harrison were not alone in their admiration of the company. Like the entire business press and the entire investment establishment, they were duped by what we have learned were aggressive misrepresentations of the company's financial condition.

The bulk of Mr. Harrison's investment in Enron – approximately 90 percent by my calculation from published reports – occurred before the company's restatements of assets and earnings. The relevant issue is not his investment in a particular stock that lost money; it is, instead, the structure of his portfolio. Was he dangerously overweighted in Enron? In other words, did he have too much stock in that one company in relationship to his other holdings? Not at all. Did his losses in Enron seriously impair his overall performance? Again, no. An average annual return of 16 percent over 17 years is exceptional. Imagine one of your constituents at age 31 turning over $10,000 to Mr. Harrison to invest for retirement at age 64. At a 16 percent rate of return, the constituent would have a nest egg of well over $1 million.

Does Congress have a legislative role here? Again, no. The Florida state pension fund and similar funds should select and oversee their own managers without federal interference. They are fully capable of deciding who should manage their money. It is a shame, however, that the trustees have handled this matter in the politically and emotionally charged way they have. If they don't like the way particular managers perform, then they can fire them. If laws are broken, they can ask for prosecution.

So what are we doing here?

Promote Financial Education

Congress can serve a constructive function in the aftermath of the Enron scandal. That function is educational. It is a fact and a blessing that the majority of Americans now own stock. Many of them, however, do not understand the basics, let along the intricacies, of investing. Teaching them is what I try to do in my columns and books, but government leaders can also play an important role. Let me close by listing what I believe are the lessons to small investors from the Enron collapse:

Diversify. If a stock like Enron is among only five or 10 stocks you own, then you're in big trouble, but if Enron is part of a widely diversified portfolio -- as it should be -- then you can pick yourself up, take your tax loss and move on.

Be skeptical of the experts. Wall Street has a herd mentality. Not only do analysts have a bullish bias, but, worse, they have a sheepish bias. They don't want to stand out from the flock. So if a few top analysts start buying a story, then practically every analyst buys the story. In the case of Enron, it was a famous short-seller, James Chanos, who started asking questions about the company's financial statements. Chanos, of course, had an ax to grind himself because, by selling short, he made money if the stock fell. But he proved an important point for small investors: Often, in the market, as in life in general, it is better to listen to non-conforming argument than to the conventional wisdom.

Recognize that bad things happen to good investors. Events such as the Enron debacle are part of the risk inherent in investing. They'll always occur. Mr. Harrison said of Enron, "On the surface it had always seemed to be a fairly good growth stock." It did, but it wasn't. However, investment professionals who bought the stock for their clients' portfolios were not venal or corrupt. They simply took at face value what the company reported in its official filings, and they were deceived. Mr. Harrison and others bought Enron stock after adverse revelations, but they too believed that the company still had valuable assets. This was a mistake but not an outrageous one. Through diversification, he protected the bulk of his account. That's a key lesson for small investors.

Take Personal Responsibility. Finally, all investors need to understand that their choices in financial investing are their own responsibility, just as their choices in home-buying are their own responsibility. They should not expect to be bailed out by lawyers or politicians. Thanks to the incredible financial democracy and diversity that has developed in the United States, small investors can take advantage of professional management and analysis at low cost, or, at even lower cost, they can simply own index funds that reflect the entire market. Investors who have proceeded in this way, with clear-headed, long-term strategies, have done very well. Over the past 20 years, an investment in the 30 stocks of the Dow Jones Industrial Average, with dividends re-invested, has increased about 20-fold.

We should not frighten people away from investing. Whether we like it not, for most Americans, stock-market investing represents not just the best way, but the only way, to build a large enough nest egg for a comfortable retirement. Yes, we need to protect and nurture investors, but we should not treat them like fools or babies. We need them to give them the tools – including accurate reporting and good financial education -- to make their own responsible choices.

Thank you.